TESTIMONY OF PROF. REUVEN S. AVI-YONAH
HEARING ON HOW OTHER COUNTRIES HAVE USED TAX REFORM
TO HELP THEIR COMPANIES COMPETE IN THE GLOBAL MARKET

U.S. House Committee on Ways and Means

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Chairman Camp, Ranking Member Levin, and distinguished members,

Thank you for inviting me to testify at this hearing. My name is Reuven Avi-Yonah and I am the Irwin I. Cohn Professor of Law and the Director of the International Tax Master of Law program at the University of Michigan Law School. I hold a JD (magna cum laude) from Harvard Law School and a PhD in History from Harvard University. I have over twenty years of full and part time experience in the tax area, and have been associated with or consultant to leading law firms like Wachtell, Lipton, Rosen & Katz and Cravath, Swaine & Moore. I have also served as consultant to the US Treasury Office of Tax Policy and as member of the executive committee of the NY State Bar Tax Section. I am currently Chair of the ABA Tax Section Committee on Tax Policy and Simplification, a member of the Steering Group of the OECD International Network for Tax Research, and a Nonresident Fellow of the Oxford University Center on Business Taxation. I have published thirteen books and over 90 articles on various aspects of US domestic and international taxation, and have seventeen years of teaching experience in the tax area (including basic tax, corporate tax, international tax and tax treaties) at Harvard, Michigan, NYU and Penn Law Schools.

In this testimony, I would like to address five points:

1. Adopting a territorial tax system is not relevant to the competitiveness of U.S.-based multinationals. Instead, what will help is plugging the holes that allow companies to shift income to tax havens, and that give other countries a competitive advantage over the United States in attracting investment capital from this country.
2. Adopting territoriality would be helpful in addressing the "trapped earnings" phenomenon, but this problem can be addressed in other and less disruptive ways.
3. Adopting territoriality without plugging the holes now in the international tax system carries serious risks of exacerbating income shifting, which is more of an issue for the US than for our trading partners.
4. Adopting territoriality without limiting the deductibility of expenses related to foreign source income will result in revenue losses we can ill afford.
5. Looking to other countries to support a case for territoriality is misplaced because it ignores key differences between the US and those countries.

1. Territoriality and Competitiveness

The leading proposals to reform the US international tax regime envisage permanently exempting dividends from foreign subsidiaries of US-based multinationals from the income of their US parents. This is a limited version of territoriality because Subpart F would still apply to passive income of those Controlled Foreign Corporations (CFCs).

This type of limited territoriality has recently been adopted by the United Kingdom and Japan, so the US is one of the few members of the OECD to continue to tax its multinationals on world-wide income. Thus, it is argued that the US should follow suit to maintain the competitiveness of its multinationals and to prevent US-based multinationals from moving to other countries.

However, the territoriality issue is not relevant to competitiveness. To the extent that taxes influence competitiveness (which is primarily determined by other factors), the competitiveness of US-based MNEs is determined by the overall effective tax rate they face compared to the overall effective tax rate faced by multinationals based in our major trading partners.[1] **There is no good data indicating that the effective tax rate faced by US-based MNEs is significantly higher than that faced by MNEs based in other OECD countries**. Moreover, as discussed below, there is reason to believe that the effective tax rate faced by US-based MNEs on foreign source income is **lower** than that faced by MNEs based in our trading partners.

Territoriality is about whether US-based MNEs will pay taxes on dividends distributed by their CFCs. Since US-based MNEs typically do not receive such dividends unless the US tax is covered by foreign tax credits, this tax has no impact on their competitiveness because they do not pay it. There is no reason to believe that US-based MNEs face any limitations in transferring funds either among their CFCs (since such transfers are now exempt from Subpart F), or on their ability to raise capital in the US. Most US MNEs are presently accumulating large amounts of cash, and they can easily access the capital markets for more, at very low interest rates. The territoriality debate has no impact on these funding decisions.

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[1] While the statutory tax rate is important for income shifting, the actual burden borne by US-based and foreign based MNEs is the one relevant to competitiveness, since that is the rate that determines what the actual after tax profit of any given project will be. MNEs need to know this rate both for internal purposes and for financial reporting. I would, however, support reducing the US statutory rate if it can be done in a revenue neutral fashion (like our trading partners did when they reduced the rate but expanded the base of their corporate income taxes).

Nor is territoriality needed to keep US-based MNEs from migrating to other jurisdictions. This may have been an issue for the United Kingdom because of the relative ease of corporate migration within the EU, but when US MNEs attempted to migrate through inversion transactions, they never migrated to our major trading partners. Our migrations were always purely nominal ones to Bermuda, and those were effectively stopped in 2004. The threat of corporate migrations is a bogus one, because if it were so easy for MNEs to migrate, no OECD country could have collected significant revenues from the corporate income tax. The most convincing answer to the argument that corporate taxes must be cut because of corporate mobility is the stability of revenue from the corporate tax in OECD member countries, which indicates that while their statutory corporate rates were indeed reduced, the effective rates (which determine competitiveness) have stayed roughly the same in the era of globalization.

2. Territoriality and Trapped Earnings

If competitiveness is not a reason to adopt territoriality, is there another reason? The answer is a qualified yes: Territoriality (i.e., exempting dividends from CFCs) can address the trapped income problem. US-based MNEs have a significant amount of foreign source income (as much as $1 trillion, based on financial statements) that they do not repatriate because it is earned in low-tax jurisdictions and will therefore trigger a US tax without foreign tax credit under current rules.

This issue was presumably one of the reasons that led the UK and Japan to adopt territoriality. Their economies are in worse shape than the US, and they needed the repatriations more than we do, given the amounts of idle cash in the coffers of the parents of US-based MNEs.

Nevertheless, there are good reasons to believe that the trapped income problem is real. First, it is clear that US-based MNEs are leaving a lot of income permanently reinvested overseas. Second, when a temporary amnesty from the dividend tax was declared in 2004, over $300 billion in such earnings were in fact repatriated. Third, the IRS has been combating various schemes ("Killer Bs", "Deadly Ds" etc.) that were designed to repatriate foreign earnings while avoiding the dividend tax. These facts suggest that the tax on foreign source dividends impacts behavior while collecting little revenue.

However, this does not mean we have to adopt territoriality, especially given the profit shifting issues discussed below. The trapped earnings problem would also be solved if we repealed deferral, since then the foreign earnings would be subject to current US tax and there would be no tax on repatriations. We could do this without affecting competiveness if we also reduced the corporate tax rate, as suggested by Senators Wyden and Coats in their tax reform proposal. Moreover, if we repealed deferral, our major trading partners may follow us, just like they followed us in

adopting CFC legislation. The result would be a much better world, in which all major MNEs are subject to a single low tax on their worldwide earnings, without incentives to shift income to tax havens. The spread of CFC legislation (over 30 countries and counting) shows that there can be a race to the top in international tax, not just a race to the bottom.

3. Territoriality and Profit Shifting

In choosing between the two potential solutions to the trapped income problem (territoriality and ending deferral with a lower rate), the key consideration has to be protecting the US domestic corporate tax base. The main problem with territoriality is that it will significantly increase the incentives to shift income to low-tax jurisdictions. Currently, US-based MNEs know that such income shifting will result in more trapped income, and so they leave some income in the US. If there is no tax on dividends and foreign source income is exempt, the pressure on transfer pricing and the source rules will increase exponentially.

But what about our trading partners? The key point here is that our major trading partners in fact tax foreign source income more than we do, because their CFC rules are stricter. The typical CFC rules in the OECD, including the UK and Japan as well as the large continental European countries, take into account the effective tax rate in the source jurisdiction while determining whether the parent must include the income on a current basis. Thus, in our major trading partners, if (a) the source country has a low effective rate and (b) the CFC has no real business activities in that source country, the result is current taxation.[2]

Our Subpart F, especially with the recent (post 1994) additions, is much more porous. It does not take the effective foreign tax rate into account (except to exclude "high taxed" income, which almost never happens) and it counts as "active" financial income and royalty income that can easily be earned in tax havens. Moreover, Subpart F (IRC 954(c)(6)) actively encourages the artificial shifting of income from high to low tax jurisdictions. As a result, despite our "world-wide" system and our trading partners' "territorial" system, **our major trading partners tax the foreign source income of their MNEs more than we do**. That is the reason they could adopt territoriality without fearing too much income shifting, and also the reason US MNEs will never migrate to any of our major trading partners.

If we adopt territoriality without reforming Subpart F, the source rules (e.g., the passage of title rule) and transfer pricing, the result will be a significant erosion of the US domestic corporate tax base. Deferral is already our biggest corporate tax expenditure ($73 billion). We cannot afford to expand it further by converting it to

[2] For a description of these CFC rules see Joint Committee on Taxation, Background and Selected Issues Related to the U.S. International Tax System and Systems that Exempt Foreign Business Income, JCX-33-11 (May 20, 2011).

exemption, and the best course would be to get rid of it altogether in the context of an overall corporate tax reform.

4. Territoriality and Expense Deductibility

It has, however, been argued that adopting territoriality would raise revenue, rather than lose it.[3] This argument, however, crucially assumes that we will in fact disallow all expenses allocated to the newly exempt foreign source income.

In pure tax policy terms, expenses allocated to exempt income should not be deductible, because the result is tax arbitrage and negative effective tax rates. That is what we do domestically. But even the Obama Administration has backed away from restricting the deductibility of R&D that gives rise to foreign source income, lest they drive such R&D to other countries (a more realistic fear than corporate migrations, since US-based MNEs do in fact conduct R&D in tax free zones in various non-OECD countries). And it seems unlikely that Congress will enact significant restrictions even on interest deductibility, which has been proposed by the Administration repeatedly with no results. In the absence of such restrictions, territoriality becomes a revenue loser, which we can ill afford given the budget deficit.

5. The Context of Tax Reform

But, it will be said, how could our trading partners afford to enact territoriality, given that they also face large budget deficits? The answer is that their tax policy context is quite different, and that it is a crucial mistake to focus solely on the territoriality issue without taking that broader context into account.

What are some crucial differences between the US and our trading partners? First, they are smaller economies, and therefore depend more on foreign trade than we do. This also makes it more likely that their MNEs will migrate (e.g., from the UK to Ireland) since they do not have a huge domestic market to serve (and many MNEs need to be close to their main market). Second, their economies are typically in

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[3] For various proposals with different revenue estimates depending on the assumptions regarding expense deductibility see National Commission on Fiscal Responsibility and Reform, The Moment of Truth (December 2010), pp. 28-35; The President's Economic Advisory Board, *The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation*, August 2010, pp. 89-91; U.S. Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century,* December 20, 2007; President's Advisory Panel on Federal Tax Reform, *Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System* (November 2005); Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02- 05), January 27, 2005, pp. 186-97.

worse shape, so that they need repatriations more. Third, and most crucially, they all have higher personal income tax rates, as well as a VAT.

This brings us all the way back to where we started- the question of competitiveness. It is a mistake to compare the competitiveness of US and foreign-based MNEs by focusing solely on the effective corporate tax rate. Not less relevant are the personal income tax rates borne by their managers and employees, as well as the VATs borne by their employees and customers. If these non-corporate taxes are taken into account, the effective tax rate on US-based MNEs, as well as purely domestic US businesses (incorporated or otherwise) is significantly lower than that on MNEs based in our major trading partners.

These non-corporate taxes also explain why our trading partners could afford to adopt territoriality. Not only did they need repatriations more and could combat profit shifting more effectively, they could also easily make up for any lost revenue by raising the personal income tax rates and the VAT rates, as the UK did when it adopted territoriality. In the US, raising individual income tax rates to European levels is off the table, and we do not have a VAT. Thus, we cannot afford to follow in the lead of Japan and the UK, even if it were otherwise advisable to do so.

6. Conclusion

To conclude, let me restate the main arguments made above:

a. Adopting territoriality is irrelevant to the competitiveness of US-based MNEs.
b. Adopting territoriality could help eliminate the trapped income problem, but so could abolishing deferral, which we could do if we lowered the corporate rate.
c. Adopting territoriality would increase incentives to shift income out of the US.
d. Adopting territoriality without limiting the deductibility of expenses allocated to exempt dividends would lead to revenue losses
e. Following the lead of other countries who adopted territoriality without considering their different economic and tax policy circumstances is a mistake.